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LIGHT ON THE COURTS

For Lawyers and Laymen

NUMBER 2

Privilege Becomes Property Under the Fourteenth Amendment: The Consolidated Gas Decision

Two Articles—Reproduced from THE INDEPENDENT

— BY —

JESSE F. ORTON

This inquiry is not concerned with the public or private misdoings of judges, with their past affiliations or present habits; it has to do with the quality of the logic and justice which they put into their decisions.
"By their fruits ye shall know them."

Published by the Author, Elmhurst, N. Y., 1912

ANNOUNCEMENT.

The two articles in this pamphlet (No. 2) take up the most important features of the remarkable litigation, in the United States Circuit and Supreme Courts, over the statute prescribing the 80-cent rate for gas in New York City. In the final determination of this case the people "got *the decision*" but the corporations "got *the law*". At least they claim to have gotten it. If they are right, the people of the United States are doomed to pay millions of dollars each year as dividends on "capital" consisting of franchise values, increase in land values, and pavement values. Special attention is called to the second article (p. 8), which deals with two of the most vital questions in the regulation of public utility rates. The appendix (pp. 14-15) contains quotations from eminent leaders in legal and political thought.

Another pamphlet (No. 1, sold on the same terms as this) has been issued, reproducing:

From *The Independent*, two articles entitled, "The Confusion of Property with Privilege: the Dartmouth College Case", taking up the little known history of that early and celebrated case and analyzing the decision of the United States Supreme Court. This decision was the foundation of many later adjudications and has been "one of the chief bulwarks of privilege".

From *La Follette's Weekly Magazine*, an article entitled, "Is This Administering Justice?", dealing with two decisions of the Pennsylvania Supreme Court between the people of Philadelphia and their rapid transit monopoly. In these decisions the court not only reverses itself but sets aside certain well known laws of mathematics and economics.

From *The Twentieth Century Magazine*, an article entitled, "'Leaders of the Bar' and the Income Tax Amendment", treating of an attempt by certain eminent lawyers to defeat the amendment in New York. Although this article does not deal with a judicial decision, it has a bearing on the material from which courts are made and has to do with an important practical question not yet definitely settled.

The author has set out to analyze, for the profession and the general public, certain judicial decisions, selected chiefly from those between the people and public service corporations.

Further articles are in course of preparation, dealing with important decisions of the New York Court of Appeals, the United States Supreme Court, and other state and federal courts.

Communications are invited, by way of criticism or otherwise.

"Mr. Orton is a lawyer with thorough economic training received at the University of Michigan and Cornell University." *The Independent;* March 11, 1909.

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Privilege Becomes Property Under the Fourteenth Amendment: The Consolidated Gas Decision

BY JESSE F. ORTON, A.M., LL.B.

First Article—Franchise Value.

(Reprinted from *The Independent* of October 12, 1911.)

THE people are becoming interested in courts and judges as never before. Not only are they convinced that the "law-making function" of the courts (theoretically non-existent but in fact very real) needs looking after, but they are inquiring into ordinary decisions to see whether they are founded on justice and common sense. Many judges and lawyers do not like this. They have sought to keep the law a sealed book, a mystery hidden from the people in technical and tedious judicial opinions. The layman might know the result; but for him to understand the "how" or the "why" of it was considered impossible. For him to criticise was thought not only presumptuous on account of his ignorance, but almost sacrilegious, as indicating a lack of proper "respect for the courts". But the day of immunity from popular scrutiny and judgment is rapidly passing.

In weighing the records of their judicial servants, the people's attention is strongly attracted to decisions affecting the rights and privileges of public service corporations; for in these days a judge's decisions in such cases are probably the surest indication whether he is a just and faithful servant. Tested by this standard, the Supreme Court of the United States has made many good decisions; but the bad ones are all too numerous, and their effectiveness for evil is great in proportion to the power and authority of the court. Sometimes in the same decision good and bad elements are strangely combined. To a striking example of this class the reader's attention is here invited. It is the case of the Consolidated Gas Company *v.* the City of New York.[1]

In 1906 the legislature passed the law regulating the price of gas in Greater New York, by which a rate of 80 cents per thousand feet was prescribed for Manhattan Island. The Consolidated Gas Company, having a complete monopoly of supplying both gas and electricity in the Borough of Manhattan and a practical monopoly through the entire city, contested this law in the federal courts, claiming that the 80-cent rate would not bring a fair return on the capital required in the business. The case turned chiefly upon the question, What was the actual value of the company's property?[2] The company insisted that account should be taken, not only of its material, tangible property, but also of certain intangible forms, like franchises or good will.

[1] 157 Fed. Rep. 849; 212 U. S. 19.

[2] This is often a decisive question in this class of cases. If, for example, the legislature prescribes a rate under which a company will earn 6 per cent on a capital of $1,000,000, the action will be constitutional. But if it be made to appear that the company's property is worth $2,000,000, the return becomes only 3 per cent on the capital invested and the rate will be held confiscatory.

In the United States Circuit Court for the Southern District of New York, Judge Charles M. Hough held the 80-cent rate confiscatory and issued an injunction against the enforcement of the law. This was the result of his estimating the value of the company's property at nearly $60,000,000, in which was included $12,000,000 of franchise value. The United States Supreme Court reduced the total value to less than $56,000,000. This was low enough to make it doubtful whether the 80-cent rate was confiscatory; the Supreme Court, therefore, reversed the decision of Judge Hough and required the company to put the new rate to a practical test and see whether it would not yield a fair return. The franchise value on which the company was legally entitled to earn dividends was reduced by the Supreme Court to $7,781,000. This sum did not represent a dollar's investment by the company—merely franchise privileges received *gratis* from the state.

A few moments' thought will convince one of the absurdity of including the market value of a franchise, a mere right to use public streets, as a part of the property on which a company is entitled to earn dividends and of which it cannot be deprived by legislative regulation.[3] When a public service corporation charges rates that yield only a fair return on its property aside from franchises, there will be no income left over to be considered as income on its franchise, and the franchise will have no market value. But when rates yield more than a fair return on non-franchise property, the excess will be capitalized into franchise value. To say that the legislature must respect this value as "property", is to say that it cannot reduce rates at all. In other words, excessive rates make franchise value; reduction of rates to a reasonable figure wipes out franchise value; therefore, to forbid this wiping out forbids reduction of rates.

This truth, considered as a general proposition, was recognized by both courts. For example, Judge Hough, referring to the claim for a return on franchise value, said:

"As an original proposition, I believe this claim unsound. Return can be expected only from investment, and he that invests must part with something in the act of investing. He that hath not sown shall not reap. . . ."

But, while acknowledging this common-sense rule that franchise values are not "property" as against the state's right to regulate rates, each court found a reason for not applying the rule in this instance or for applying it only in part. The position taken by Judge Hough in the Circuit Court is peculiar. Although stating that the "crucial point" had not yet been decided by "the highest tribunal", he decided this case contrary to his own judgment, as expressed in the language above quoted. He concluded that he was "compelled to consider franchises not only as property but as productive and inherently valuable property, and to add their value, if ascertainable, to complainant's capital account".

By way of explanation, he tells us that often "the decision of the trial court is guided, in the absence of directly controlling authority, by the trend of decisions and methods of reasoning pursued in well considered cases dealing with kindred topics". After referring to certain decisions supposed to show a "trend" toward the doctrine contended for by the company, Judge Hough says:

"Instead of attempting to minimize and distinguish the decisions to which I have been referred and many others, it is my duty to follow the method of reasoning there clearly indicated, leaving it to the higher tribunals to make distinctions which, if drawn by the lower court, would in my opinion savor of presumption."

If Judge Hough and his colleagues could only know that the people, for whose service they are chosen, are waiting, yea, longing, for a judge who will be presumptuous in the cause of common sense, logic and justice! Would that they could see that the public trust reposed in them forbids them to decide contrary to their own sense of right and reason in deference to anything short of unequivocal superior authority! Then, if reversed, a judge might have the compensation of being right. In this case, on the general proposition, Judge Hough has the double discomfort of being both wrong and reversed.

The Supreme Court did not recognize the "trend of decisions" toward allowance of dividends on franchise values in all cases; but in this case it allowed the company's franchise value, to the extent of $7,781,000, to be considered "property" entitled to earn dividends, on the theory that the legislature in 1884 authorized the capitalization of these franchises at that amount.[4]

By the law of 1884 the legislature authorized corporations engaged in manufacturing to consolidate, and prescribed the method of doing it. The directors of the consolidating companies were to make an agreement providing, among other things, for the amount of capital stock in the new company, which capital, the law directed, should not be "larger in amount than the fair aggregate value of the property, franchises and rights of the several companies thus to be consolidated". After this agreement had been approved by the stockholders of each company, the stock of the new company might be issued to the stockholders in the old companies, and the process of consolidation would be complete.

A few months after the enactment of this law,[5] six of the seven gas companies in New York City were merged into one corporation, the Consolidated Gas Company. The seventh company planned to join in the merger, but withdrew when its officers discovered that the company's charter made them subject to criminal prosecution if they should vote to combine with other gas companies. The "fair aggregate value" of the franchises of the six companies was fixed at $7,781,000 by agreement of their directors and stockholders, and stock of the new company was issued sufficient to cover this amount as well as the agreed value of the physical property. The entire amount of capital stock was increased by the consolidation from $17,000,000 to $39,078,000.[6]

The Supreme Court held the franchise value fixed by the companies, $7,781,000, to be constitutional "property", merely on account of the provision in the law of 1884, that the stock issued by the new company should not exceed "the fair aggregate value of the property, franchises and rights of the several companies" consolidated. There was nothing else in the law to serve as a basis for the decision. The court construed this *prohibition* as a *license* to the companies *to capitalize their franchises at an agreed amount and earn dividends forever on that sum* in spite of legislative regulation of rates. Whether this decision was that essence of wisdom, logic and justice which we have a right to expect from our highest court, the reader may judge.

1. *What does the law of 1884 itself say on the subject?* The court makes no mention of section 5 of the law. That section, after providing that consolidation should operate as a transfer of all property and all "rights, privileges, franchises and interests of every kind" from the consolidating companies to the new company, continues:

"And such new corporation shall hold and enjoy the same, and all rights of property, privileges, franchises and interests *in the same manner, and to the same extent*, as if the said several companies so consolidated had continued to retain the title and transact the business of such corporations. . . ."

It would not be creditable to the learned justices of the Supreme Court to assume that they did not read and consider the whole of the law (only three pages) on which they decided that the legislature made the Consolidated Gas Company a present of $7,781,000 of the people's money. Nor is it creditable to the justices to assume that they read, but did not heed, this plain language, which seems to have been carefully designed to fit a case like this.

The new company was to hold and enjoy the franchises "in the same manner, and to the same extent" as the old companies would have held and enjoyed

[3] If money has been paid into the public treasury for a franchise, the question may arise whether the owner should be allowed to capitalize the franchise at the sum paid. That question is not here considered.

[4] See Chapter 367 of the Laws of 1884.

[5] The passage of the law was secured by the gas companies themselves.

[6] No increase of stock could have been made under the consolidation law in force prior to the law of 1884. There had been enormous watering of stock throughout the history of the several companies. The stockholders of one company, who had never paid in but $750,000, received no less than $7,560,000 of stock in the consolidated company.

them if there had been no consolidation. One of the conditions on which each of these franchises was granted and held, was that the state might reduce rates to a reasonable amount based on the actual property of the company. This, therefore, was one of the conditions on which the Consolidated Gas Company was to hold and enjoy the franchises of the six consolidating companies; and the Consolidated Company had no standing in court to claim that the law of 1884 impaired the state's power to regulate charges for gas supplied by that company.

2. *If section 5 be disregarded, is it true that the legislature gave up any of its power to regulate rates?* The Supreme Court held, not that the general power of regulation was given up, but that the state, by authorizing the issuing of stock for the value of the franchises, made that value "property", of which the holder could not be deprived "without due process of law"; therefore, legislative reduction of rates could not go to the extent of preventing fair dividends on this stock. The reader has probably perceived the fatal defect in this theory.

If we grant, for the sake of argument, that the legislative *prohibition* against issuing stock for more than the "fair value" of the "franchises" was, in effect, a *license* to issue stock up to the limit of such value, the vital question remains, On what basis was this value to be fixed? Were not the franchises to be valued just as they stood, as a horse is appraised just as he stands, with all defects and infirmities? The franchises were then subject to the infirmity that the legislature might so reduce rates as to wipe out part or all of the franchise value, just as a horse is subject to the natural infirmity that he may die within a month. Ordinary sense, the sense of horse-jockeys, would have told the companies in 1884 that they were not authorized to appraise or value anything except *what they then had, namely, franchises subject to the legislative regulation then allowed by the constitution.* The market values of their franchises were subject to annihilation by regulation of rates. Undoubtedly, even with this infirmity, the franchises would then have commanded some price in the market, especially in view of the kind of legislatures with which the state had been blessed for many years. But nothing could be plainer than that the stockholders in the gas companies, who issued this stock to themselves, to represent their own valuation of their franchises, simply took their chances on future legislative reduction of rates. The persons who later purchased a portion of the stock took the same chances. Similar risks have been taken by the holders and purchasers of millions of shares of stock of public service corporations, representing mere franchise values, before and since 1884. For the stockholders in the gas companies to think they could appraise their franchises, which were then subject to a definite and vital condition, and thereby rid them of that condition, had no more logic or sense in it than for a horse-trader to think that by paying a hundred dollars for a horse he can rid it of the infirmities of nature which may impair or annihilate its value at any time.

3. *The effect of the decision.* It appears from the opinion of the court that prior to 1884 the gas companies' rates had never been regulated by law and, as a result, excessive dividends had been paid, in some cases averaging more than 16 per cent annually from the creation of the companies. In 1884 the six companies paid dividends of nearly 25 per cent on actual investment. The price of gas was then $2.25 per thousand feet. The Supreme Court in effect says that the legislature of 1884 addressed the gas companies in some such manner as this:

"We are the trustees of the people, for whose service you were created and were given extraordinary privileges. We have the power, and it is our duty, to fix the price which the people must pay you at a reasonable sum, so that your compensation for this public service shall not be excessive. We have neglected this duty in the past, and your profits have been treble and quadruple what was reasonable. You may now combine into one corporation and capitalize your franchises, which you received *gratis* from the people, at such sum as would be considered 'fair' if it were quite certain that we would continue to neglect our duty and let you charge the same prices which now yield your excessive dividends. The stock which you may issue to represent this valuation of your franchises will be sacred 'property', protected by the constitution against any impairment through a reduction of your prices by ourselves or our successors, world without end. Amen."

4. *The court's argument.* The court ignored the express language of section 5, reserving all rights and powers of the state, ignored the fact that, in the very nature of things, the valuation of the franchises had to be made on the basis of then existing powers of regulation held by the state, and adopted the alternative theory that the legislature authorized the companies to appraise and capitalize their franchises at such sum as would be their "fair value" if the rates then existing were not to be reduced by law.[7] Such a basis of valuation would have been bad enough under any circumstances; but in 1884 rates were being kept up by methods that were scandalous in character.

The court reviews the report of a legislative committee appointed in 1885 "to investigate the facts surrounding the consolidation" of the gas companies. The committee concluded that under conditions existing in 1884, "the valuation of $7,781,000 for the franchises was not more than their fair aggregate value".[8] What were those "conditions"? (1) The enormous dividends paid by the gas companies; (2) a law which "virtually prohibited the laying of any more gas pipes in the streets"; (3) an agreement between the gas companies "fixing the price of gas at a figure that paid these dividends"; (4) a contented public paying this price "without objection or protest"; and (5) the existence of no law that made these high rates or excessive dividends "illegal".

It was no secret that the law which "virtually prohibited" the laying of competing gas pipes had been put through the legislature, concealed in a provision relating to *steam* pipes. It was well known that the agreement between the companies "fixing the price of gas", which had been in force since 1880, was accompanied by all the marks of a "pool" or "trust", division of territory, suppression of competition, the pooling of earnings, etc. "Condition" 3 and "condition" 5 could not exist at the same time. The price-fixing agreement and the "pool" which made it effective were plainly "illegal" at common law, as the Supreme Court knew by its own decisions as well as those of other courts;[9] and the taint extended to the resulting rates and dividends.

Yet the court complacently comments thus on the committee's report:

"Assuming, as the committee did, that the company would be permitted to charge the same prices in the future which in the past had resulted in these 'enormous' or 'excessive' dividends, it need not be matter of surprise that a franchise by means of which such dividends had been possible was not regarded as over-valued at the sum stated in 1884."

Merely because the legislature *forbade* the companies to issue stock for more than "the fair aggregate value of the property, franchises and rights" of the several companies, was the court to hold that the legislature *authorized* the companies to capitalize their own unlawful conduct, to determine a "fair value" of the right to continue extortionate charges and make them effective by a scandalous and illegal combination, and then to earn and pay dividends on this "value" forever, at the expense of the gas consumers of New York, in spite of future regulation of the price by law? To say that the legislature meant to do this, was to impute a foolish and presumably corrupt purpose to the law-making body. It is a well established legal principle that this is never to be done unless such an intent is expressly shown in the language employed by the legislature. No such intent, or shadow thereof, can be found in the law of 1884.

The Supreme Court did not attempt to meet this situation by referring to any

[7] No claim is made that the amount $7,781,000 was more than a guess. Judge Hough said: "For all that I can see, the franchises of 1884 might as well have been valued at twice the amount of the stock then issued on the faith thereof. It was nothing but an attempt to capitalize expected profits; but the attempt now has twenty years' success to justify it." (Printed record, p. 425.)

[8] This was merely a Senate committee and had no authority to bind the state by its conclusions. Moreover, it recommended a reduction of rates, and the legislature reduced them from $1.75 to $1.25 per thousand feet. The Consolidated Company had made a voluntary reduction from $2.25 to $1.75.

[9] See Gibbs *v.* Baltimore Gas Company, 130 U. S. 396, and cases cited; also Charleston Gas Company *v.* Kanawha Gas Company, 58 W. Va. 22, and People *v.* Milk Exchange, 145 N. Y. 267.

words contained in the law; it merely said:

"We think that under the above facts the courts ought to accept the valuation of the franchises fixed and agreed upon under the act of 1884 as conclusive at that time. The valuation was provided for in the act, which was followed by the companies, and the agreement regarding it has always been recognized as valid, and the stock has been largely dealt in for more than twenty years past on the basis of the validity of the valuation and of the stock issued by the company."

If the agreed valuation of franchises be "conclusive", why should not the valuation of the physical property also be conclusive? But no one, apparently, has thought of suggesting so absurd a result. The appraisal of physical property was subject to this, among other possibilities, that a new invention might soon reduce or wipe out its value. In like manner, the appraisal of franchises was subject to the possibility that the state would lower the rates charged for gas and thus reduce or wipe out franchise values. The appraisal agreement between the stockholders of the gas companies, valuing these franchises, may have been "valid", as the court says, but why should it bind any one except the persons who made it? The $7,781,000 may have been represented by "valid" stock, but it does not follow that an income of six per cent was guaranteed. There is much "valid" stock which yields no income whatever. The argument of the court is simply "beside the mark".

All this seems evident on the face of it. But if we invoke the well established rule that when a person or corporation claims privileges inimical to the public welfare, all doubtful questions must be resolved in favor of the people, there can be no uncertainty as to the result.

5. *Was it necessary to construe the word "franchises" so as to include the gas companies' right to realize on their faith that future legislatures would be like those gone by?* Undoubtedly, their "faith" was not of the sort which is "dead" because it is "without works"; but did the court have to give their faith such life as to make it net them $7,781,000? The word "franchises" might well have been construed as including only rights legally enforcible against the state. If, for example, a company was authorized by law to charge 90 cents per thousand feet for gas, such a right might have been held to be included under the term "franchises", while mere hope or expectation of legislative indulgence in regard to rates was held to be excluded. Courts have often made less obvious distinctions and in worse causes. Under this construction, the law of 1884 *forbade* the issuing of any stock for these gas franchises.

Second Article—Land and Pavement Values.

There are two other points in the decision of even greater importance, involving the right of the company to receive an income on more than $13,000,000.[1] It was claimed that this was part of the company's "property" on which the state could not, by regulation of rates, prevent the making of a reasonable profit. In other words, it was alleged to be property of which the company could not, under the federal constitution, be deprived "without due process of law".

Some preliminary explanation is necessary. As the courts construe the federal constitution, state legislatures and commissions and city councils must allow

[1]The exact amounts of the two items making up this total, were not determined by the court; and the company presented little evidence for the purpose of showing the amounts. The figures used here are taken from the brief filed in the Supreme Court on behalf of the city by its Corporation Counsel, Francis K. Pendleton, now a Justice of the New York Supreme Court, and Ex-Judge Alton B. Parker. They seem to be sustained by the evidence in the case, and are more conservative than those contended for by other eminent counsel representing the defendants.

public service corporations to charge rates yielding a fair return on the property "devoted to the public use". The method of determining the value of a company's property used for a public service has, therefore, been a matter of prime importance. Was this "property" the total amount of bonds and stocks issued by the company? This theory, though put forward in some early cases, received no permanent recognition. The absurdity of making the people pay dividends on whatever paper a company had seen fit to issue, was soon apparent in spite of the plea of "innocent purchasers".

Next came the "original cost" or "actual investment" theory,[2] according to which an income might be earned on the amount invested in cash or in equivalent property. There were strong arguments in support of this method. It allowed an income on what individuals had really parted with, and no more. It had the advantage of simplicity and certainty, provided the books of the company were correctly kept; for the books would show the amount of money paid in and the cost of the various items of property. And if a public utility enterprise were launched judiciously and conducted properly, the payment of rates yielding dividends on "actual cost" would seldom be an unreasonable burden.

But many public utilities were not launched judiciously or conducted properly; and the total of so-called "actual investment" was often far above legitimate capitalization based on value. The "investment" was often excessive, even when the management had been fairly efficient and free from peculation. An illustration will make this plain.

Suppose that a gas plant has been built at a cost of $1,000,000; that annual repairs require 1 per cent of the cost, or $10,000; that there is a further annual depreciation of 2 per cent, or $20,000; and that the income of the company, after paying operating expenses, is 10 per cent, or $100,000. Under proper management, of course, 1 per cent would be expended each year for actual repairs; 2 per cent would be set aside in a "depreciation fund" to be used for rebuilding the plant when worn out and for replacing certain parts from time to time; and not more than the remainder of the net income, or 7 per cent, would be used in paying dividends. But the practice of many public service corporations has been, to pay in dividends not only the 7 per cent really earned but also the 2 per cent required to offset depreciation and sometimes part or all of the 1 per cent needed for current repairs.

[2]Cost and investment are the same thing, of course, if the money paid in by stockholders is neither stolen nor wasted but is invested in property or services.

Years afterward, when a new plant must be built or the old one be brought to a state of efficiency, the cash is obtained by selling more bonds or stock. Thus the security-holders may have "actually paid in" $2,000,000, although the plant is still worth only $1,000,000, the explanation being the payment of unearned dividends equal to $1,000,000. If the business is unprofitable, as a result of unwise planning or dishonest or inefficient management, the same result may be reached without the payment of dividends, new capital being required to provide for repairs and depreciation in the absence of income available for those purposes.

It became clear that, under conditions often prevailing, the amount of money "actually invested" was a wholly unjust measure of the income deserved, and that this standard, as a hard-and-fast rule, was an impracticable one by which to limit the power of the state to regulate rates. It was also perceived that, so far as depreciable property was concerned, like buildings, tools and fixtures, it was usually impossible to tell what the "original cost" had been, impossible to draw the line between new capital legitimately supplied for improvements or extensions and that improperly applied to repairs or replacements.

In view of these objections to "cost" or "investment", it was proposed to adopt the "present value" of the company's property as a standard, to be found by appraising the property on the basis of the cost to reproduce it and then deducting a suitable amount for "accrued depreciation". It was not clearly seen that "original cost" is in many ways the best standard obtainable; and that if it could not be retained as a fixed and in-

variable rule, it could and must still be used, to prevent gross injustice, in fixing the value of certain kinds of property for rate-making purposes. Public service corporations were not slow in seeing the advantage to be gained by insisting on a strict application of the "present value" standard; and the tendency of many courts has been toward its adoption as the sole "property" test of the constitutionality of rate regulation, although in the leading case of Smyth *v.* Ames[3] the United States Supreme Court said that several other things might be considered, including "original cost of construction".

We now take up the two points above mentioned, arising in the Consolidated Gas Case; (1) as to the valuation of land, and (2) as to the valuation of pipes under street pavements.

1. *Valuation of land used for a public utility.* The "present value" standard was expected to save the public from fraud and injustice in fixing the capital value of buildings, machinery, railway tracks, water or gas pipes—in brief, property subject to wear and tear. The application of the rule to the valuation of land was wholly unnecessary; land does not wear out or have to be repaired, and if it becomes unsuitable for use by a public utility it can be sold for another purpose.

The original companies whose franchises passed to the Consolidated Gas Company in 1884, began business at various times from 1823 on. It appeared in 1906, according to the findings of Judge Hough in the United States Circuit Court, that the value of the company's land was $11,985,435. But this land appears to have cost the gas companies, at the times of purchase in earlier years, a total of not more than $4,118,267. $7,867,168 had been added to its value by the growth of New York in population and industry.[4] Were the gas consumers required by the federal constitution to pay such rates as would yield dividends on nearly $8,000,000 which the company had never invested? They are now paying such rates, and both Judge Hough and the United States Supreme Court say they must continue.[5]

[3] 169 U. S. 466.

[4] See note 1.

The question was not whether the company should be recognized as the owner of this value and entitled to sell the land for its market price whenever it discontinued the gas business. The question was, Shall the people of New York, after creating this value by their presence and industry, be required to pay to those who have not created it an annual income upon it in the form of rates for a public service?

Governments exist for the performing of public services; they occupy the position of trustees for the benefit of the people, bound to furnish or secure the desired service at the lowest practicable cost. Certain services are inherently public because they at once require the use of public property, inevitably become monopolies in private hands, and are universal necessities. Such are the services furnished by street railways, gas, water and electric plants, telephone systems, etc. As to these services, the government may adopt either of two courses; it may provide the service itself and make a charge sufficient to cover the cost, or it may license private parties to provide the service under the control of government and make a reasonable charge therefor. What is a reasonable charge? The only possible answer is, the lowest charge that will secure the desired service; the government is a trustee for this very end and is recreant to its trust if it permits a private purveyor of a public service to impose a higher rate.

It is clear that dividends on any increase that may occur in land values are not necessary, in order to attract capital for the furnishing of gas or other public utilities. The reasons are obvious.

(a) The fact and the extent of such increases are largely fortuitous; at least, any great increase is seldom certain when the land is purchased and business begun.

(b) Without any dividends on increase of land value, a public service corporation derives as great a benefit

[5] The statement by the Supreme Court may be considered an *obiter dictum*. The suit of the company, sustained by Judge Hough but reversed and dismissed by the Supreme Court, might have been dismissed without any statement as to the valuation of land. But this *dictum* will be followed by many inferior courts until the higher court makes a contrary ruling.

from the general industrial fact that land values may increase, as is derived by private business enterprises. The courts uphold public utility rates yielding an income equal to the percentage generally obtained by successful private enterprises of a similar character *upon their original investments;*[6] and the general fact of possible increases in land values will certainly be reflected in this customary rate of profit. To allow this percentage to be reckoned on a capital greater than the amount invested in a public utility, would be to place the utility corporation in a position more favorable than that occupied by the ordinary private enterprise of a like character.

(c) By denying to a public service corporation profits on the increase in the value of its land, the court would not prevent it from receiving a great advantage from such increase. It would be the owner of that value, the taxes thereon being paid each year by its customers as a part of its operating expenses. To make the people pay dividends as well as taxes on a value which represents a pure windfall to the company and is a result of the whole community's growth and industry,[7] cannot be considered necessary in order to secure the service which the company furnishes.

In support of his holding that the people must pay profits on money which the Consolidated Gas Company never invested, Judge Hough says:

"If fifty years ago, by the payment of certain money, one acquired a factory and the land appurtenant thereto, and continues to-day his original business therein, his investment is the factory and the land, not the money originally paid; and unless his business shows a return equivalent to what land and building, or land alone, would give if devoted to other purposes (having due regard to cost of change), that man is engaged in a losing venture, and is not receiving a fair return upon his investment, i. e., the land and building."

[6] Judge Hough, after stating that "an interest in the gas business" of New York "is as nearly a conservative investment as any private manufacturing enterprise can furnish", decided that a "prudent man acquainted with business", if offered such an investment, would take it on a six per cent basis, and would be legally entitled to that rate in spite of legislative regulation, because that "is the return ordinarily sought and obtained on investments of that degree of safety in the City of New York". The Supreme Court affirmed the decision with reference to this point on the reasoning employed by Judge Hough.

[7] The Consolidated Gas Company's counsel, in speaking of the increase in the value of the company's land, said: "It is due to Divine Providence and the growth of the City of New York." (Printed record, p. 2833.)

The reader will see that Judge Hough ignores the vital and controlling feature of the case, the difference between purely private enterprises and public services. The "return" must be "fair" to the people as well as to the corporation; and anything above what is necessary to attract the needed capital, is unfair, a special favor conferred by government in violation of its duty as trustee for all the people.

It is sometimes said that a company should be allowed to earn an income on the appreciated value of land because it may be required to accept a return on a depreciated value not only for land but also for buildings, machinery and other similar property. Thus Judge Hough says:

"Nor can it be inferred that such government (any American government) intended to deny the application of economic laws to valuation of increments earned or unearned, while insisting upon the usual results thereof in the case of equally unearned, and possibly unmerited, depreciation."

In case land has decreased in value since its purchase and the deficiency has not been made good out of earnings, of course the original cost should be taken as a basis in determining reasonable rates, provided the purchase was proper and made at a fair price. The resulting public losses would be rare and comparatively insignificant. As to other property, the argument will be seen to have no foundation. The company is allowed not only to make repairs out of income, but also to set aside a sum equal to the annual depreciation from such causes as can be foreseen, all in addition to receiving a fair return. If there are any dangers of loss that cannot be foreseen, any risks which make the investment less safe than a good mortgage, for example, the company is allowed a percentage of profit large in proportion to the risks assumed. In this case Judge Hough made an allowance for "depreciation", to be taken out of income as a part of the expense of the business; and he named six per cent as the proper rate of return in view of the risks incurred by the company.

The Supreme Court seems to uphold Judge Hough's ruling as to the increase of land value shown in this case, while not committing itself as to such increase in all cases. The court says:

"We concur with the court below in holding that the value of the property is to be determined as of the time when the inquiry is made regarding the rates. If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase. This is, at any rate, the general rule. We do not say there may not possibly be an exception to it, where the property may have increased so enormously in value as to render a rate permitting a reasonable return upon such increased value unjust to the public. How such facts should be treated, is not a question now before us, as this case does not present it."[8]

All of this might be paraphrased by saying that it is permissible for the public to be mulcted of a lamb, though possibly it would not be right for it to be mulcted of a sheep.* The *amount* of the increase in land value would seem to be immaterial, except that the public hardship would be greater in case of a large increase. And the "lamb" in this case would seem to be nearly grown into a "sheep", a matter of about $8,000,000, nearly one-seventh of the company's property as reduced by the Supreme Court.

Thus, without vouchsafing any reason for "the general rule" or any practical clue to the possible "exception to it", and with nothing but a cursory reference, the Supreme Court dismisses the subject. Whether its language amounts to mere *dictum* or is settled law, the State and City of New York, and all other states and municipalities, are practically given notice that they must allow the earning of dividends on capital amounting to hundreds of millions of dollars, which no company ever invested or produced.

2. *Dividends on cost of city pavements.* It often happens that a gas, water or electric company places its pipes or wires under streets before they are paved or while they are paved with a cheap material. In due time the city paves or repaves the streets, laying down perhaps "asphalt over concrete" or "granite block". If the company were to lay the pipes or wires over again, removing and replacing a costly pavement and having to contend with a greater accumulation of fixtures under the street surface, the cost would probably be much greater than the original cost of putting them in, or the present cost if the original conditions still existed. In other words, the "reproduction cost" of the company's property has been vastly increased by expenditure of the taxpayers' money.

Shall the gas-consuming public pay dividends to the company because the people have covered the company's pipes with good pavements? It is difficult to see how the proposition can be taken seriously; yet it has been boldly argued by companies' lawyers and has received the approval of judges.

It appeared that the reproduction cost of the Consolidated Gas Company's mains and service pipes would be greater, by $5,555,761, on account of the changed conditions in the streets, chiefly new paving.[9] These improvements did not belong to the company, and it had paid nothing on account of them. Nevertheless, Judge Hough decided that the people must pay dividends to the company on this immense sum. He said:

"If it be true that a pipe line under the New York of 1907 is worth more than was a pipe line under the city of 1827, then the owner thereof owns that value, and that such advance arose wholly or partly from difficulties of duplication created by the city itself is a matter of no moment."

Shall the standard of "present value", after being used to prevent injustice in one direction, be allowed to become the instrument of equal or worse injustice in another direction? Is it "a matter of no moment" that the people are taxed to lay pavements, and then pay an extra gas rate equal to six per cent or more on the value of the improvement? They also pay, as part of the company's operating expenses, any incidental increase in the cost of repairing mains and pipes under the pavements.

The United States Supreme Court did not either repudiate this doctrine or give its express approval. It said, as already quoted:

"If the property, which legally enters into the consideration of the question of rates, has increased in value since it was acquired, the company is entitled to the benefit of such increase."

While there is room for argument that when the court used the words, "property, which legally enters into the consideration of the question of rates", it did not refer to such a value as that arising from improved pavements,—yet this language of our highest court is constantly being urged, by counsel for public service corporations, upon courts and commissions throughout the country, as an undoubted approval of the holding of Judge Hough. In certain quarters it may be accepted in that sense, and the people interested will have to take their case to the United States Supreme Court —if, indeed, they can get it there—to find out what that court meant.

Judge Hough thought the 80-cent rate would produce a net income of about $3,000,000, slightly more than five per cent on the value of the company's property and franchises, placed by him at nearly $60,000,000. He held the rate unconstitutional because it would not yield six per cent. The old rate, $1 per thousand, was yielding nearly ten per cent. Curiously enough, Judge Hough, as he himself tells us, allowed "nothing for increase of sales due to cheaper prices". Why did he not make allowance for this? On appeal, the Supreme Court said:

"A reduction in rates will not always reduce the net earnings, but on the contrary may increase them."

Even though the reduction from $1 to 80 cents might not actually increase net earnings, it was certain that the lower price would cause an increased consumption of gas and thus offset, in whole or in part, the loss of income due to the reduction.[10]

The Supreme Court cut down Judge Hough's valuation of the company's franchises from $12,000,000 to $7,781,000. This left the total investment less than $56,000,000, on which the net income anticipated by Judge Hough would be nearly 5½ per cent. While agreeing that the company was entitled to six per cent, the Supreme Court reversed the Judge's decision and compelled the company to make a trial of the new rate, to see whether, with the increased consumption of gas due to the lower price, it would not yield six per cent. It has undoubtedly yielded six per cent or more; the company has made no attempt to reopen the case and show that it found the rate insufficient. The Supreme Court was also influenced by a doubt whether Judge Hough, relying upon the testimony of expert witnesses furnished by the company, had not fixed the value of the tangible property at too high a figure.

If the court had eliminated from the total of the company's investment (1) all franchise value, (2) the increase in the value of the company's land, and (3) the alleged increase in the value of mains and pipes due to better pavements, these items amounting to more than $21,000,000, the capital would have been reduced to about $34,500,000, on which even Judge Hough's estimated net income would have been 8.79 per cent, with a still higher percentage to be earned through increased consumption.

The rate should be further reduced to a figure that will yield no more than six per cent on the company's fair capitalization.[11] The Supreme Court should have another opportunity to pass on the franchise value supposed to have been authorized by the legislature of 1884. It should have a chance to reconsider "the general rule" as to increase in land values, and, incidentally, to say whether an increase of nearly $8,000,000 is not "enormous" enough to make payment of dividends on it "unjust to the public". It should also say definitely whether the people must pay dividends on value created solely by the expenditure of taxpayers' money in the laying of pavements.

[8] See note 5.

*This sentence did not appear in the article, as published in *The Independent*.

[9] See note 1.

[10] This is shown by the experience of the company since the 80-cent rate became effective by the Supreme Court's decision (January 12, 1909). Under the dollar rate the consumption of gas, from 1905 to 1908, showed an average annual increase of only 366,000,000 cubic feet. Under the 80-cent rate the consumption increased 937,000,000 cubic feet in 1909, and there was a further increase of 726,000,000 feet in 1910.

[11] It should be noted that six per cent on the entire value of the property is equivalent to seven per cent for the stockholders, if they have issued bonds at five per cent equal to half that value. No opinion is here expressed as to the propriety of six per cent as a rate of return in this case.

The opinion of the Supreme Court, nominally against the company, but really in its favor on the most important issues in the case, was given by Justice Peckham and received the concurrence of all the other members of the court; Chief Justice Fuller and Justices Harlan, Brewer, White, McKenna, Holmes, Day and Moody.[12] Thus was the legislative sword, drawn against monopoly, turned back into the vitals of the people, in whose protection it had been raised. A prohibition designed to check over-capitalization had been transformed, in the judicial crucible, into a license for extortion. Thus, as often happens, the people got *the decision*, but the corporations got *the law*—for future use.

Respect for the courts and confidence in them are necessary to successful popular government. But it is no less necessary that such respect and confidence should be withheld unless they are earned by just and reasonable official action. In order to secure an intelligent and fair attitude on the part of the people, they must know and understand the facts. Let them turn upon the judgments of the courts the searchlight of analysis, common sense and good conscience. If what they discover brings a falling off in the traditional respect and confidence, that fact should, and probably will, contribute toward the adoption of means for the removal of the causes. It is more dangerous to proceed in ignorance than it is to know the worst.

[12]Since the decision of this case the court has lost five of its members, Chief Justice Fuller and Justices Harlan, Brewer, Peckham and Moody. Justice White has been made Chief Justice and Justices Lurton, Hughes, Lamar, Van Devanter and Pitney have been appointed.

Appendix.

BY BROOKS ADAMS

"It is a noteworthy fact that the cause which we, as American citizens, have been taught to call the cause of liberty and of equal rights, has owed more to the courage of the soldier than to the wisdom of the judge. In moments of crisis in the long career of the English-speaking race, the courts have inclined toward the dominant class, and these judicial decisions have sometimes been corrected by the mandates of legislative assemblies, it is true, but sometimes also by the swords of champions like Cromwell, William III, and Washington. Thus we have come to view our greatest constitutional triumphs, not from the standpoint of the lawyers who sustained privilege, but from the standpoint of the men who fought the battles of rebellion for equality. * * *

"As I have already shown by the precedents, the tendency of courts is to support particular dominant interests at the public cost, and this soon proved to be as true in the United States as in England. During the first quarter of the last century the judiciary went far toward undermining the foundation upon which the common right must always rest. They held that American legislatures had the power to alienate forever and beyond recall, in favor of private persons, not only public property held in trust for the whole people, but sovereignty itself. They held that legislatures could not only bind themselves and their successors forever to a remission of taxation, but that an ordinary charter of incorporation, such as a turnpike or railway charter, was a contract which could not be modified without the consent of the grantee.

"Had the principle of constitutional law embodied in these early decisions been carried out logically to its legitimate end, I apprehend that the American people must long since have fallen into abject servitude to monopoly, or a revolution must have ended an intolerable situation."

In a brief submitted to the Interstate Commerce Commission in City of Spokane *v.* Northern Pacific Railway; 15 I. C. C. Rep. 376, 19 *id.* 162. Mr. Adams is the eminent author of "The Law of Civilization and Decay" and other political and economic works.

BY JUDGE SEYMOUR D. THOMPSON

"The Dartmouth College decision put the private corporation above the legislatures of states which were at that time called 'sovereign'. * * * It was followed by an orgy of political corruption and profligacy probably unparalleled in the history of our race. * * * Legislative bodies in some states literally became the paid agents and tools of particular corporate institutions. * * * The orgy which surrounded the halls of legislation extended to the temples of justice and the judges were swept into the maelstrom. * * * They drifted with the tide so far as to forget to be impartial. Their intellects were hoodooed when great corporations stalked into their courts in the persons of eminent counsel. Unconsciously they did most of their thinking on the side of the corporation."

In American Law Review; Vol. 26, p. 169. Judge Thompson is the well known author of "Commentaries on Law of Corporations", "The Law of Negligence", and other legal works.

BY ARTHUR T. HADLEY, LL.D.

"Neither the judges who decided the Dartmouth College case nor the legislators who passed the Fourteenth Amendment had any idea how these things would affect the modern industrial situation. * * * Yet the two together have had the effect of placing the modern industrial corporation in an almost impregnable constitutional position.

* * * * *

"Under these circumstances, it is evident that large powers and privileges have been constitutionally delegated to private property in general and to corporate property in particular. * * * The general status of the property owner under the law cannot be changed by the action of the legislature or the executive, or the people of a state voting at the polls, or all three put together. It cannot be changed without either a consensus of opinion among the judges, which should lead them to retrace their old views, or an amendment of the Constitution of the United States by the slow and cumbersome machinery provided for that purpose, or, last—and I hope most improbable—a revolution."

From "The Constitutional Position of Property in America", in *The Independent* of April 16, 1908. Dr. Hadley is President of Yale University.

BY DELOS F. WILCOX, Ph.D.

"Any one who has observed the processes of political power knows that the same political methods by which presidents, governors, legislators and aldermen are created will not always select judges who are above reproach, even though the choice is limited to members of the legal profession. The truth is that all kinds of men occupy the bench, among them men who secured their positions through all the different degrees of political chicanery practised in American politics.

"Judges appointed for life, having no fear of the power of the people or of the executive to rebuke them, are likely to interpret the law according to their own interests and sympathies, whatever they may be. As for the judges who are elected for definite terms, if they desire to remain upon the bench they have to consider the powers that make the nominations and finance the campaigns. To provide for themselves if they are defeated at the polls or if they retire from the bench voluntarily, they are tempted to look forward to possible retainers from the great property interests—retainers that can never be had unless during their judicial service they have proved to be staunch defenders of property. Judges, like other men, are more likely to deserve criticism in proportion as they are protected from it."

From "The Issue Beyond the Parties", in *The Independent* of October 22, 1908. Dr. Wilcox is the author of "The American City", "Municipal Franchises", and other works in political science.

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